

April 18, 2022

**VIA ELECTRONIC SUBMISSION**

Ms. Vanessa A. Countryman, Secretary  
U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, D.C. 205499-1090

Re: **File No. S7-02-22**

Dear Ms. Countryman:

We appreciate the opportunity to provide our views to the Securities and Exchange Commission (“SEC” or “Commission”) on its proposed rulemaking in File No. S7-02-22, and specifically the proposal to amend the definition of “exchange” in Rule 3b-16 under the Securities Exchange Act of 1934 (“Exchange Act”) to include “communication protocol systems.”<sup>1</sup>

**I. “Regulation by enforcement” should not become “regulation by surprise”**

This comment focuses on what the proposal does *not* discuss: whether the SEC intends the phrase “communication protocol systems” to cover computer code deployed on a blockchain (or the people who deploy or maintain that code), which computer code may allow users to purchase, sell or otherwise transact in cryptographically-secured digital assets without an intermediary. Given its recent intensive focus on digital assets and their regulation, it would be surprising indeed if the SEC and its staff had not considered these questions in depth—and had not developed a view on their answers—before the Commission voted, but there is not a whisper of the SEC’s intentions on this topic in the proposal’s 650-plus pages.

Bottom line: the proposal fails to give clear and specific notice to a potentially regulated class, and, as a result, it fails to grapple with the legal and practical issues that would arise if the SEC intended to regulate that class. The SEC has been criticized for pursuing a strategy of “regulation by enforcement” over crypto. While that may be somewhat unfair, particularly given the difficulty of regulating a space as fast moving and varied as crypto, we should not add “regulation by surprise” to the complaints—especially when we are on the cusp of a national crypto strategy that should guide regulation in this area.<sup>2</sup>

To avoid the regulatory uncertainty that the proposal would likely sow, we request that the SEC:

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<sup>1</sup> See Exchange Act Release No. 94062, 87 FR 15496 (Mar. 18, 2022) .

<sup>2</sup> See Executive Order on Ensuring Responsible Development of Digital Assets (Mar. 9, 2022) (the “National Strategy Executive Order”), available at <https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/>.

- clarify that the new definition of “communications protocol systems” is not intended to apply—and will not be applied—to such protocols, even if relating to “digital asset securities” (because if it were, the proposal would have said so), and delay any further regulatory proposals in this area until after the President’s National Strategy Executive Order is sufficiently deployed so it may be done in a manner consistent with that strategy;  
*or*
- if, though not mentioned or analyzed in the proposal, such protocols *are* intended to be covered in the new definition of “communications protocol systems,” refrain from issuing a final rule in this area until at least:
  - the President’s National Strategy Executive Order is sufficiently deployed, so the proposal may be developed in a manner consistent with that strategy, *and*
  - the SEC issues a supplemental notice of proposed rulemaking that, among other things:
    - provides clear notice to and solicits meaningful comments from the proposed affected class;
    - gives the affected class more than 30 days to read, understand, consider, consult, identify, model, assess, and discuss these rules and comment upon them;
    - clearly and unambiguously defines “communication protocol system;” and
    - details how the definition of “communication protocol systems”—especially as applied to autonomous software, software that facilitates peer-to-peer transactions, and other disintermediated crypto applications—is authorized under the United States Constitution and the definition of “exchange” in Section 3(a)(1) of the Exchange Act (which we do not believe it is).

The balance of this comment letter operates under the assumption that the proposal does, or may in the future, contemplate regulating crypto under “communications protocol systems.”

## **II. Interests of the commenters**

We are team members at investment firms that deploy private capital into promising, technology-focused companies and projects, including those that use blockchain technology. We write in our personal capacities because we have each had the pleasure of working with the SEC staff on matters both unrelated to and within the crypto industry. We understand the difficulty in regulating novel technologies and markets and the good faith with which the SEC staff has approached this field for the better part of a decade.

We believe that crypto has the potential to bring greater freedom, autonomy, and economic benefit to people around the world. We also believe that, while this technology is by its nature global, the U.S. legal and regulatory landscape should encourage its development on American soil. This will make it more likely that our citizens and our financial markets reap its benefits, our economy grows, and our technologists shape the future in a way consistent with the rule of law.

As the President recognized in the National Strategy Executive Order, we must remain at the **forefront of crypto development**, and a U.S. regulatory scheme that disincentivizes the development of crypto technology is not in the national interest. However, regulatory haziness could lead to these undesirable results and more, including impeding U.S.-based crypto ventures from raising capital. This will have the foreseeable downstream effects of stifling innovation, impeding job creation, and ultimately stanching the provision of useful applications and economic opportunity for current and future users. For these reasons, we are concerned with the implications of the SEC's proposal.

### **III. The SEC should regulate in this space, if at all, in the context of the President's national crypto strategy**

In the National Strategy Executive Order, the President mobilized the executive branch to consider broad national interests—economic empowerment, national security, job creation, consumer protection, and crime prevention—in developing a unified strategy on digital assets. The results of that process, we hope, will clarify which agencies should regulate crypto and how, and charge that the agencies that regulate crypto consider those broad national interests alongside their statutory mandates.

The SEC's history with crypto has seemed both more singular in focus and, at times, unable to provide sufficient clarity or guidance to those the agency would seek to regulate. This has not encouraged growth and development of crypto in the U.S. We think it has had the opposite effect.

If intended to cover crypto under “communication protocol systems,” this proposal would be a prime example of a lack of clarity. The proposal's failure to address crypto head-on (as discussed below) has already caused uncertainty and confusion, undermining the National Strategy Executive Order's goals of national competitiveness, economic opportunity, and national security. Commissioner Peirce foreshadowed this outcome when she broadly warned “[r]ead this release . . . you should not assume that it has nothing to do with you, because it probably does.”<sup>3</sup> The chilling effect on the industry is detrimental not only to the protocols, entrepreneurs, and innovators forced to navigate a murky regulatory framework and take on

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<sup>3</sup> See Hester Peirce, “Dissenting Statement on the Proposal to Amend Regulation ATS,” (Jan. 26, 2022), available at <https://www.sec.gov/news/statement/peirce-ats-20220126>.

regulatory risk (in addition to business risk), but to investors who seek to deploy capital in this environment.

Even as federal government's work is underway to carry out the National Strategy Executive Order, this proposal seems to jump the gun by bringing digital assets technology under the SEC's regulatory ambit before the administration's whole of government assessment makes significant progress. We believe that the SEC should refrain from proposing new regulation applicable to crypto or digital assets until the President's national strategy on responsible crypto innovation is determined across the federal regulatory landscape, so that this proposal—at least to the extent that it applies to crypto—may be developed in a manner consistent with that strategy.

#### **IV. The consequences of regulation by surprise**

##### **a. The regulated class has no reasonable chance to weigh in**

Good rulemaking requires agencies to follow rules that many of us learned in grade school: “Show your work.” “Describe the who, what, when, where, why, and how of the story.” The lesson is that the process one follows is in many cases just as important as the conclusion itself.

These lessons are applicable in rulemaking because the process puts people on notice that something important is happening, that it may materially affect them, and that they have a chance to weigh in on the outcome. For administrative agencies, unlike for grade schoolers, adhering to those tenets isn't just expected—it is mandated by the Administrative Procedure Act, (“APA”). The APA outlines how regulatory agencies are to conduct “notice-and-comment” rulemaking—so designated because the potentially regulated class is to be given adequate notice of the proposed rule, and an opportunity to provide meaningful comments relevant to the agency's decision making.

To gain meaningful participation from the public, a proposed rule must “fairly apprise interested persons of the issues in the rulemaking.”<sup>4</sup> Courts look for *clarity* and *specificity* when determining whether interested parties had the opportunity to participate in the rulemaking in a meaningful and informed matter.<sup>5</sup> This is so because an agency won't receive meaningful comments if it doesn't give clear notice.

And here, no clear and specific notice was given to the potentially regulated class. The proposal's 650+ pages contain no mention of crypto, digital assets, blockchain technology, decentralized finance (“DeFi”), decentralized exchanges (“DEXes”), automated market makers (“AMMs”), or any related technology. And that is not because the proposal leaves all potential regulatory targets to the reader's imagination: it contains a list of technologies that the SEC

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<sup>4</sup> Jeffrey S. Lubbers, *A Guide to Federal Agency Rulemaking* (4th ed. 2006) at 282 (citing cases).

<sup>5</sup> *Id.*

intends to be included in the definition of “communications protocol systems,” none of which mention crypto, digital assets or blockchain technology.<sup>6</sup>

The problem here is that the exclusion of crypto might lead a reasonable reader—and certainly might lead a potential regulated person—to conclude that there’s nothing to see here, no need to comment, no need to provide views. But this is almost certainly not the case. Without “showing its work” or fully answering the “who, what, when, where, why and how” of the proposal, the SEC has created a situation where, without providing clear and specific notice, it could attempt to apply amended Rule 3b-16 under the Exchange Act to crypto and DeFi protocols.

With the SEC’s decision to not squarely address crypto in the proposal, not only was the potential (or even probable) regulated class not given required notice,<sup>7</sup> but the SEC deprived itself of the opportunity to conduct the analyses required under the Exchange Act<sup>8</sup> and the Paperwork Reduction Act of 1995.<sup>9</sup> The only discussion in these sections relates to communication protocol systems handling traditional securities (*i.e.*, stocks, bonds, swaps)—not tokenized securities or digital assets or crypto-related transactions that the SEC may regard as securities under its Framework for “Investment Contract” Analysis of Digital Assets<sup>10</sup> or other legal theories. Only through an explicit determination to not apply the proposal to crypto could these analyses be complete and correct; the entire proposal contemplates the existence of a mere 22 communication protocol systems—a number that clearly does not include the significant number of DeFi systems and digital asset exchanges currently in existence.<sup>11</sup>

**b. The proposal fails to disclose or grapple with practical issues that a final rule would create**

The technology underlying the crypto industry is unique in many ways, including that it removes intermediaries and central operators from transactions, and provides unparalleled transparency

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<sup>6</sup> Examples of communication protocol systems included in the proposal include “setting minimum criteria for what messages must contain; setting time periods under which buyers and sellers must respond to messages; restricting the number of persons to which a message can be sent; limiting the types of securities about which buyers and sellers can communicate; setting minimums on the size of the trading interest to be negotiated; or organizing the presentation of trading interest, whether firm or non-firm, to participants.” *See* Exchange Act Release No. 94062 at 15507.

<sup>7</sup> *See* 5 U.S.C. § 553.

<sup>8</sup> Exchange Act Section 3(f) requires the Commission, when it is engaged in rulemaking pursuant to the Exchange Act, to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

<sup>9</sup> The Paperwork Reduction Act of 1995 requires that an agency conduct an analysis and provide an estimate of the burden that shall result from a collection of information. *See* 44 U.S.C. § 3507.

<sup>10</sup> *See* Division of Corporation Finance, Framework for “Investment Contract” Analysis of Digital Assets (April 3, 2019). Available at <https://www.sec.gov/files/dlt-framework.pdf>.

<sup>11</sup> *See* Exchange Act Release No. 94062 at 15586.

and auditability. Its regulation merits intentional, unambiguous, and public consideration. The SEC's decision to not include its thinking on crypto in the proposal deprived the public of the ability to weigh in on these important points. Specifically, the SEC should have provided answers to at least these questions:

- How does the SEC envision the proposed rule working for DeFi protocols?
- Who does the SEC envision being responsible for registration and ongoing compliance of a DeFi protocol? A DEX,<sup>12</sup> for instance, has no central party that could register or impose terms on its behalf. What does the SEC intend for such systems?
- Against whom would the SEC act if an alleged violation is caused by self-executing lines of code on a blockchain?
- Which person or party would register with FINRA, and how would FINRA be charged with facilitating such member registrations?

These questions have knock-on effects that the proposal similarly does not disclose or consider. For instance:

- Would the Commission view liquidity providers (*e.g.*, those establishing or contributing to pools on AMMs) to be the functional equivalent of market makers on a centralized exchange?
- Would they be viewed as traders and outside of the SEC's regulatory remit, or instead as dealers that themselves would need to register, given their role in what would be considered an alternative trading system under the revised rule?<sup>13</sup>

### **c. The SEC's legal authority for the proposed change is tenuous**

Proposed Rule 3b-16 may represent an impermissible expansion of the SEC's statutory authority, whether applied to digital assets or not. But especially because crypto, DeFi, and other emerging

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<sup>12</sup> A decentralized exchange, or DEX, is a peer-to-peer (or peer-to-protocol) protocol facilitated through smart contracts deployed to a blockchain network. Although not uniform in construction, a defining feature of a DEX is that no single party maintains administrative control over the peer-to-peer protocol and, in some instances, the protocol may not be changed, halted or permanently removed. An analysis of such systems and the degree to which administrative capacities may attach thereto is beyond the scope of this letter; more importantly, it is also beyond the scope, text and defined intent of proposed Rule 3b-16, raising significant questions as to whether proposed Rule 3b-16, as currently drafted, may be applied to such DEXes.

<sup>13</sup> We note that in the recent proposal to amend the definition of "dealer" under Section 3(a)(5) of the Exchange Act, the Commission at least included a single reference to digital asset securities (albeit in a footnote), unlike the current proposal. *See* Exchange Act Release No. 94524 (Mar. 28, 2022). But even one mention is insufficient to articulate the agency's views and show that it has satisfied its statutory obligation to, among other things, weight the costs, benefits, and other legal and economic effects of that other proposal.

technologies were left out of the proposal, the SEC eliminated its own opportunity to disclose and analyze this question, and the potentially regulated class's chance to comment on it.

The proposed expansion of “exchange” to include the open-ended and new regulatory category of “communications protocol systems” would cover activities that are well beyond the scope of authority prescribed by the Exchange Act, *i.e.*, “performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood.”<sup>14</sup> The primary function of a stock exchange, and the function it is generally understood to perform is the exchange of stock. This generally understood meaning cannot be broadened to include all potential ancillary services or the activities of an undefined communication protocol system (let alone the non-dispositive examples included in the proposal). If we consider examples offered in the proposal of these systems, it seems clear that the examples do not describe the function of a stock exchange as that term is generally understood. Setting minimum criteria for what messages must contain? Restricting the number of persons to which [sic] a message can be sent? Organizing the presentation of trading interest, whether firm or non-firm?<sup>15</sup> These examples do not describe “exchange” activity over which the statute authorizes regulation.<sup>16</sup> The SEC does not have the authority to expand its interpretation of the term “exchange” to include merely adjacent or proximate activities.

## V. Conclusion

Regulation of crypto and DeFi, in particular, should come from thoughtful and transparent collaboration between lawmakers, regulators, and the industry. A regulation by surprise approach—a rule that could implicate crypto and DeFi protocols without even mentioning them, let alone analyzing their effect on them—is not the answer. This is especially so where the proposed rule jumps the gun on the National Strategy Executive Order, and where the legal underpinnings for the rule may be more tenuous. If applied to crypto and DeFi and the participants and technology in these areas, the proposal would be in contravention of the SEC's tripartite mission by (i) harming investors, their existing investments, and future investment opportunities; (ii) creating confusion and disorder among crypto markets and their participants; and (iii) significantly harming opportunities for capital formation.

It is imperative that the SEC clearly articulate its views on whether the proposal would apply to crypto and DeFi protocols. Without showing its work or explaining the who, what, when, where, why, and how, the proposal may further alienate the creative minds who are driving this space forward, fracture what faith the industry might have in the agency, and drive innovation away

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<sup>14</sup> See 15 U.S.C. § 78c(a)(1).

<sup>15</sup> See Exchange Act Release No. 94062 at 15507.

<sup>16</sup> Butressing this is the SEC's own statement that “[t]he term ‘‘makes available’’ is also intended to make clear that, in the event that a party other than the organization, association, or group of persons performs a function of the exchange, the function performed by that party would still be captured for purposes of determining the scope of the exchange under Exchange Act Rule 3b-16.” See Exchange Act Release No. 94062 at 15506.

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from America's shores. As the SEC considers regulation of crypto and DeFi, it should do so in a clear and overt manner, consistent with the developing national strategy, and in a way that will not cause harm to U.S. technological and economic competitiveness and national security. We welcome the opportunity to join the SEC in advancing that discussion.

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Respectfully submitted,

/s/ Gus Coldebella

/s/ Gregory Xethalis